

Deal Destination

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INDIAN CORPORATE DEBT MARKET: KILLING THE GOLDEN GOOSE?

The corporate debt market was a vibrant source of raising funds by Indian corporates from non-resident investors. The flexibility to decide the terms of fund raising coupled with relatively higher returns on debt ensured that the limits imposed on the quantum of aggregate debt that could be raised by Indian corporates was almost always exhausted.

The Reserve Bank of India (RBI) and the Securities Exchange Board of India (SEBI) on June 15, 2018 issued circulars which introduced limits on exposure a single foreign portfolio investor (FPI) could take into a single borrower group, as well as the maximum extent to which a single investor could subscribe in a single bond issuance. While the former was set at 20% of the debt portfolio of the FPI, the latter was set at 50% of the relevant issue.

While the overall exposure to the group seems to be lesser concern for FPIs, the changes with respect to single bond issuance exposure introduced have had an immediate impact on the debt inflows into the Indian debt market, with the utilization of the debt limits falling substantially almost immediately.

This severely impacts negotiated transactions since the regulations no longer permit a single borrower and lender to mutually agree on the terms of the debt instrument and proceed with the transaction. As an instance a borrower (B) wanted to raise funds worth INR 1 billion from an offshore FPI (L1), and the parties negotiated the terms of the funds to be lent. While L1 and B could have documented the lending transaction and proceeded to closing, the changes meant that L1 and B would now have to look for another lender (L2) to lend at least INR 500 million. L2 could be an unrelated FPI or a domestic entity. Introduction of L2 meant that either L2 accepted the terms agreed between L1 and B, or amend the terms earlier agreed between B and L1.

The intent of the RBI and the SEBI seems to be to encourage a growing public market for bond issuances, and to onshore debt raising by Indian corporates. Corporates that complied with the conditions for raising public debt preferred the public route, irrespective of the lack of limits on investments by FPI. However, by introducing the concentration norms, the regulations have only impacted negotiated transactions.

The introduction of the concentration norms has forced investors to look at alternate structures to lend to Indian corporates:

- **Arranger arrangements:** Like in typical syndicated loans, the main lender negotiates the terms of the funding with the borrower and then seeks commitments from other lenders (onshore or offshore) to lend at least half of the amount to be lent. Due to regulatory restrictions, the main lender is generally reluctant to underwrite these loans (i.e. provide commitment to ensure the entire amount is lent) and are undertaken on a best-efforts basis. The anomaly of the limit on investment makes the main lender (willing to lend the entire amount) an arranger of sorts.

While the lender may seek commitments from other lenders, it is unlikely that the terms would be substantially altered. This forces the lender to seek certain soft commitments prior to finalizing the terms with the borrower, and finalize terms which are also acceptable to the other lenders. The entire process turns out to be onerous on the borrower and the lender, increasing transaction costs, and thereby increasing the cost of raising capital for Indian borrowers.

- **Alternate structures:** The restriction of 50% is applicable only on FPIs, but not on any other lending entity. Clearly the intent is to encourage onshore lending platforms. By imposing the restriction on FPIs, the level playing field between resident and non-resident lenders has been unsettled in favour of resident lenders, which is probably intentional. As a result, FPIs have started looking for alternative structures, such as using alternative investment funds (AIF) to lend funds to Indian corporates, at least to the extent of 50%. Some of these FPIs invest into these AIFs themselves through group entities to avoid looking for third party lenders, and invest in the Indian portfolio companies directly to the extent of 50%, and use the AIF to lend the other 50%. In other cases, offshore investors are preferring to shun the FPI route altogether and use domestic entities (such as AIFs and NBFCs) to subscribe to the debt instruments being issued by Indian corporates, which results in such investors incurring unnecessary administrative costs, which may be avoided in other cases. As a result of the restrictions, investors are preferring to pool funds offshore by setting pooling vehicles offshore and invest into Indian corporates through onshore entities.

Due to the alternate structures being considered, it would appear that the circulars have neither achieved the objective to usher in a public bond market, nor has it resulted in onshoring debt structures in spirit. On the contrary, the circulars have stifled the private debt market by making structuring of investments more difficult, increasing transaction costs and encouraging structures for investment, when such structures are not needed. This has resulted in reducing foreign inflows into the country, thereby straining the Rupee as well.

Debt limits utilised since the circulars were notified, coupled with the deteriorating rupee manifest that debt investments into Indian corporates have reduced substantially, despite the relatively higher returns Indian bonds offer. While the latter may be as a result of the economic conditions on the macro-level, the former is more a direct

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result of the detrimental regulatory framework, rather than reducing appetite for Indian debt among foreign players.

While the government may have indicated its willingness to roll back the concentration norms, the flip-flop of the government and the regulatory authorities on foreign investment regimes are severely impacting India's credibility as a destination for foreign capital. As an age old saying goes:

"If it ain't broke, don't fix it"

— **Abhinav Harlalka & Ruchir Sinha**

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